

## Redefining performance

Progress has been made in ensuring alignment of interest, but today's downturn is placing strain on existing provisions. What should investors do? **Stephanie Schwartz-Driver** investigates

**F**inancial stress is putting strain on the relations between managers and their institutional investor clients, and between general partners and limited partners in private equity deals. As a result there is much talk about how to achieve alignment of interest amid a declining market.

"Typically, alignment of interest works in an upward market" says Stan Iezman, president and chief executive officer of American Realty Advisors. "It is difficult to work in a downward-spiralling market."

He suggests viewing the issue from the fund manager's perspective: "In a market as volatile as today, the manager is out of the money. It is difficult to create a structure that takes into account downside exposure."

Jeff Barclay, managing director and head of ING Clarion Partner's acquisitions group, agrees that today's volatility presents a significant challenge to all parties. "Market conditions currently are a big test of alignment of interest. Ventures are entered into by optimists. Current market conditions represent a scenario that was not anticipated by optimists."

In Barclay's view, alignment of interest is achieved at the level of the structure of the investment. "You never get perfect alignment of interest, but you try to maximise that in as many foreseeable futures as possible," he says. "It is about getting paid for the right kind of performance." To Barclay, it is essential to define what good performance means: is it maximising revenues? Is it maximising profits?

One reason people are feeling the stress now is that, in the market mania of the past few years, deals were entered into without proper forethought and planning. "One of the problems that plan sponsors are facing is that, in the later funds they entered into, they were not as careful as they should have been in documentation," notes Ted Leary, president of Crosswater Realty Advisors. "Now they are finding

out that they do not have as much as they should in terms of governance rights."

Leary also maintains that these problems are heightened among investments made by who he terms as the 'late arrivers' – smaller, entrepreneurial firms that at first sourced money from fund managers but in 2006/2007 changed tack and sought money from the pension funds themselves.

"These firms viewed funds as a capital source rather than as clients," Leary says.

"They got in late, at the top of the market. Now they are in survival mode, their assets under management are down, their revenue is down, they are not getting enough revenue to support the firm," Leary suggests. "They are looking out for themselves, not looking out for their clients. And their clients know that; they are seeing that the congruency of interest has disappeared."

**S**o what should the client do? Leary recommends a tried-and-tested approach. "Spend a day with your managers, look them in eye," he says forthrightly. He recommends performing a "congruency audit": are they being honest about their values; do they have a business plan for getting through the crisis; are they losing staff?

"Checklists are fine, but you cannot take the human element out of this," he adds. "If you are satisfied with the answers, move to the next problem. But if your antenna goes up, you have to look at getting your money out."

Leary describes the current situation for fund managers as "open kimono time", and says: "it is clear that a sizeable number of managers are not doing that now." He has some equally forthright advice for them: "If you want to be in business long-term, work with your client. Pension fund staff have long memories."

This is the approach that American Realty Advisors is taking, according to Iezman. "It comes down to

the integrity of the managers, to reputational risk. Now we are working extremely hard, for less money.

"In the real estate world there is a tendency that when the market tanks we are paid less even when more work is required. Sometimes clients need to recognise that in troubled times the emphasis needs to be not on compensating less, but the focus may need to be on compensating more to get managers to do the work required," he says.

Iezman stresses the importance of seeing the distinction between good and bad investments and market trends, and notes the need to find a way to align manager compensation to take this distinction into consideration.

"There will never be a perfect solution," he says. "We have debated this internally for years. It is just like 1979, 1988, 1991 – the same issues pop up but in a different set of clothes. I've seen every reiteration, and there are flaws in every one of them."

Iezman, too, recommends that plan sponsors look at the basics. "You have to hire high-quality managers with integrity, who have experience dealing with troubled times."

High compensation is a big issue in the US these days, with even President Obama weighing in on executive compensation, and the real estate work has not escaped some scrutiny. In this area as well, compensation became an issue in the latest boom. "What started as a really good thing, aligning the interest of general partners with limited partners so that if money is made, everyone makes it, can be taken to the extreme," says Barclay. "If the industry standard is to pay very high fees, then it becomes an arms race to pay the highest fees to retain the best people."

Current market conditions are not sustaining this "arms race" obviously, Barclay points out. "Right now, the incentive to do something is low, so the attitude of most businesspeople today is to sit tight. They do not have a high incentive to pay a lot of money to do something."

It is in the wake of down markets that new patterns of alignment arise, Barclay notes. He points to the downturn of the early 1990s, which was "by the measure of those days a disaster". He adds: "And that was when the movement toward alignment of interest became rejuvenated." As all market participants scramble toward success, the habits of the future will emerge.



**Leary: 'danger that managers are looking out for themselves'**